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JAPAN'S FOREIGN DIRECT INVESTMENT IN DEVELOPING COUNTRIES

Summary

Propelled by the strength of the yen and the magnetism of cheap labor, Japanese companies have increased their production facilities in developing countries, primarily in Asia and, to a lesser extent, Latin America, with little interest paid to the Middle East or Africa. Within Asia two trends seem to be emerging. First, the successful development efforts of the newly industrialized economies are leading Japanese companies to shift their labor-intensive assembly ventures away from the NIEs to Southeast Asia. Second, Japanese firms are relying on their overseas facilities to produce parts as well as assemble final products, thereby diversifying the range of Third World investments.

Introduction

The appreciation of the yen since 1985 has focused international attention on the efforts of Japanese exporters to remain competitive in the face of inhospitable exchange rates. Producers have used a number of strategies to survive the new climate. These include decisions to absorb some of the higher costs -- that is, consciously forgo some profits -- in a long-run strategy to retain international market share. (The fact that oil prices dropped when the yen began appreciating against the dollar somewhat mitigated the situation; Japanese firms were able to purchase energy supplies more cheaply.) Firms also have concentrated on honing research and development efforts in the hopes of discovering cost-cutting technologies or new, market-creating products.

Another essential strategy has been foreign direct investment. In the face of a near 100 percent increase in the yen's value against the dollar in just four years, Japanese firms have found it competitively necessary to shift

more production overseas -- either for local consumption or export to third markets. This is hardly a new activity for Japanese companies. But where overseas production once was limited to large firms, the yen's surge now has convinced many of Japan's small and medium-sized businesses that foreign direct investment can help them cope with their international cost handicap.

Japanese investment activities have increased in both the developed and the developing world. However, currency considerations are merely one of a substantial list of reasons Japanese firms consider investing in Third World countries. Other reasons include:

- Shortages of labor in Japan, including a dearth of people willing to work at monotonous factory jobs in contrast to the low cost of labor in developing countries;
- The shortage and resulting high cost of industrial sites in Japan;
- The increasing number of environmental laws and other regulations in Japan that affect industrial activities;
- Local content laws in Third World countries and third-country restrictions on the volume of made-in-Japan exports; and
- Easier access to industrial inputs and lower electricity costs for energy-intensive products.

Regional Distribution of Japanese Investment

Given these compelling reasons for Japanese manufacturers to invest offshore, it is tempting to assume that foreign production has increased across-the-board since the 1985 Plaza Accord. Regarding industrialized countries, this is true. The value of Japanese investment in American assembly or manufacturing facilities quadrupled between FY 1986 and FY 1988 (see Table 1), largely because the yen's appreciation made local production cost-effective for firms selling in the United States. Similarly, assembly and manufacturing activities in Europe have increased significantly. Japanese investors have an added reason to set up production facilities in European countries; the possibility of expanded local content regulations after the European Community unification in 1992 is spurring Japanese firms to establish a presence there in order to be counted as a local producer (see JEI Report No. 28B, July 21, 1989).

Investment activities in the Third World have been uneven. Among the developing regions Asia has been the overwhelming beneficiary of Japanese firms' decisions to establish manufacturing facilities overseas -- second internationally only to North America (see Table 2). The value of Japanese investment in Latin America also has skyrocketed, more than doubling between FY 1985 and FY 1988. Although total direct investment in Latin America actually exceeds the amount sent to Asia, the figures are somewhat misleading. Only 17 percent of Japanese investment in the region has gone into the manufacturing sector. Much of the remainder is "paper investment," including, for example,

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Table 1: Japan's Foreign Direct Investment by Country, FY 1984-FY 1988

(in millions of dollars)

	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988	Cumulative March 31, 1989
United States	$3,360	$5,395	$10,165	$14,704	$21,701	$71,860
Canada	184	100	276	653	626	3,231
North America	3,544	5,495	10,441	15,357	22,328	75,091
Indonesia	374	408	250	545	586	9,804
Hong Kong	412	131	502	1,072	1,662	6,167
Singapore	225	339	302	494	747	3,812
Korea	107	134	436	647	483	3,248
China	114	100	226	1,226	296	2,036
Thailand	119	48	124	250	359	1,992
Malaysia	142	79	158	163	387	1,834
Taiwan	65	114	291	367	372	1,791
Philippines	46	61	21	72	134	1,120
Asia	1,628	1,435	2,327	4,868	5,569	32,227
Panama	1,671	1,533	2,401	2,305	1,712	12,858
Brazil	318	314	270	229	510	5,596
Caymans	1	132	930	1,197	2,609	5,085
Bahama	97	298	792	734	737	2,718
Mexico	56	101	226	28	87	1,671
Bermuda	29	148	16	36	337	991
Netherlands Antilles	66	62	66	199	172	747
Peru	6	10	---	1	---	696
Latin America	2,290	2,616	4,737	4,816	6,428	31,617
United Kingdom	318	375	984	2,473	3,956	10,554
Netherlands	452	613	651	829	2,359	5,525
Luxembourg	315	300	1,092	1,764	657	4,729
West Germany	245	172	210	403	409	2,364
France	117	67	152	330	463	1,764
Switzerland	229	60	91	224	454	1,432
Spain	140	91	86	283	161	1,045
Belgium	71	84	50	70	164	1,027
Europe	1,937	1,930	3,469	6,576	9,116	30,164
Australia	105	468	881	1,222	2,413	8,137
Oceania	157	525	992	1,413	2,669	9,315
Liberia	281	159	289	267		3,658
Africa	326	172	309	272		4,604
Kuwait	55	34	41	54	20	1,383
Iran	0	0	---	---	1	1,005
Middle East	273	45	44	62	259	3,338
Total	10,155	12,217	22,320	33,364	47,022	186,356

Source: Ministry of Finance

Table 2: Japan's Foreign Direct Investment by Industry and Region, March 31, 1989

(in millions of dollars)

	North America	Latin America	Asia	Middle East	Europe	Africa	Oceania	Total
Manufacturing Sector	$23,944	$5,437	$12,371	$1,273	$4,857	$226	$1,735	$49,843
Food Products	934	223	516	0	171	8	112	1,965
Textiles	493	439	1,380	4	303	39	11	2,669
Wood and Paper Products	1,377	200	389	-	5	0	128	2,099
Chemicals	2,311	590	1,785	1,128	594	20	113	6,540
Metals	2,553	1,933	2,268	66	328	127	395	7,671
Nonelectric Machinery	2,610	378	1,037	11	626	1	54	4,716
Electric Machinery	5,952	491	2,414	14	1,261	7	56	10,196
Transport Equipment	3,030	1,050	1,183	4	913	17	759	6,956
Other	4,684	132	1,399	46	656	7	106	7,031
Nonmanufacturing Sector	49,949	26,111	19,269	673	24,098	4,374	7,526	131,999
Agriculture and Forestry	354	190	277	2	7	7	218	1,054
Fisheries	156	146	154	1	7	94	72	632
Mining	1,647	1,557	6,912	393	1,103	579	1,758	13,949
Construction	697	208	355	40	59	22	62	1,443
Trade and Sales	11,693	1,508	1,913	20	3,955	8	914	20,011
Banking, Finance and Insurance	12,370	10,990	2,509	123	14,853	22	1,009	41,876
Services	4,859	931	3,711	5	1,570	697	986	12,759
Transportation	239	9,236	584	2	101	2,079	102	12,342
Real Estate	15,782	142	1,230	-	1,386	69	1,988	20,599
Other	2,152	1,203	1,623	87	1,056	798	415	7,334
Branch Offices	714	45	551	1,389	1,171	1	48	3,919
Other Transactions*	485	23	37	2	38	2	7	595
Total	75,091	31,617	32,227	3,338	30,164	4,604	9,315	186,356

*Certain overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980.

Source: Ministry of Finance

ship registrations in Panama and various financial activities in tax havens such as the Cayman Islands.

Asia and Latin America are essentially the only developing regions that have been hosts to increased Japanese investment in recent years, however. Investors have shied away from Africa -- apart from registering ships in Liberia and engaging in a handful of resource-extraction operations. On the whole, the continent is considered both too geographically distant (from Japan or third-country markets) and culturally diverse to interest investors. Moreover, the obstacles posed by poor infrastructure, lack of trained personnel, markets limited by the dire poverty of the region and political instability are enough to persuade Japanese firms to look elsewhere.

Japan's overwhelming dependence on external oil supplies has prompted some firms to invest in petroleum-related ventures in the Middle East. However, Mitsui & Co., Ltd.'s experience in Iran stands as a cautionary light for corporate planners.

After the second oil shock in 1979, Mitsui announced plans to launch a multibillion-dollar petrochemical joint venture in Bandar Khomeini, Iran. Almost immediately thereafter, the Iranian revolution shifted the tenor of the political climate, which suffered further destabilization a year later with the outbreak of the Iran-Iraq war. Unable to secure Tehran's agreement to dissolve the project, Mitsui continued to sink money into the plant, even after Iraqi forces in 1984 bombed what already had been built.

The deathwatch for the embarrassing fiasco finally began in March 1989, when Iran and Japan agreed to begin talks to liquidate the Iran-Japan Petrochemical Co. Mitsui is expecting Tehran to make postwar reconstruction assistance a prerequisite for any separation agreement. And although Mitsui is eligible to collect investment insurance, the Ministry of International Trade and Industry has made clear its intention not to approve any claims for investments made after 1980. Current estimates put Mitsui's losses at roughly half the money it sunk into the project, a not insignificant amount. The costly implications of the IJPC failure have made Japanese companies extremely wary of investing substantial amounts in the region.

Risks of Investment

The risks associated with investing in a developing country are a constant concern to investors. Although the Bandar Khomeini experience is an extreme example, it nonetheless illustrates that investments in developing countries can turn sour very quickly. Even foreign investors in industrialized countries have cause for caution, as evidenced by many Americans' negative reaction to rising Japanese investment presence here -- despite the efforts of their state and local governments to attract foreign money. But risks generally are greater in developing countries. Japanese firms cite a number of obstacles to establishing facilities in the Third World:

- Political instability, like the Iranian example, possibly leading to physical damage to the facility or changes in the national attitudes toward investment (including nationalization of the foreign-owned company);

- Popular resentment of a significant Japanese industrial presence in the country, possibly culminating in events like the anti-Japanese riots in Bangkok and Jakarta in 1974;

- Stringent investment requirements, including laws governing export performance, local ownership ratios and local content;

- Shortages of trained host-country personnel for technical and managerial positions, either within the Japanese firm or for subcontract work;

- The tendency of non-Japanese workers to change jobs frequently;

- Difficulties in obtaining parts and other inputs from the developing host country; and

- Increasing international criticism (and possible reactions) regarding the effects of Japanese corporate practices on the global environment -- such as the degradation of rain forests in Indonesia and Brazil (see JEI Report No. 8B, February 24, 1989).

The levels of confidence that Japanese investors have in various countries is polled on a semiannual basis by the Japan Bond Research Institute, an affiliate of Nihon Keizai Shimbun Inc. Countries are rated on a scale of 2-10, with a score of 10 indicating no risk and a 2 indicating considerable risk. Selected results of the most recent survey were published by the Japan Economic Journal in March:

10.0:	West Germany, Great Britain, Canada, France	7.4:	Malaysia
9.9:	United States, Singapore	6.0:	Indonesia
9.6:	Australia	5.9:	India
9.4:	Taiwan	4.3:	Pakistan
8.4:	South Korea, Thailand, Hong Kong	3.9:	Philippines
7.8:	Kuwait	2.5:	Iraq
7.7:	China, Saudi Arabia	2.3:	Burma, Bangladesh
		2.1:	North Korea
		2.0:	Nicaragua, Afghanistan Peru, Sudan, Chad, Cuba

These ratings may give an indication of the general views of investors, but the fact that they already are a bit dated only underscores the risks in choosing offshore production sites. For example, the political violence that occurred in June in China has raised questions about the stability of that country as a host for investments -- as well as the implications for Hong Kong, which is scheduled to become part of China in 1997.

Shift From NIEs to Asean

As is evident from the rankings above, the newly industrialized economies -- Singapore, Hong Kong, South Korea and Taiwan -- inspire extremely high levels of confidence among Japanese investors, and until the mid-1980s they were the preferred sites for overseas production ventures. The "Four Tigers" had impressive drawing cards: low labor costs, relative political stability, geographic and cultural proximity to Japan and, for the most part, an eagerness

to attract foreign investment. In fact, it is commonly argued that the economic success of these countries is due primarily to their ability to attract foreign investors and absorb the technologies they pass along. (For a more detailed discussion of Japan's technology transfers to developing countries, see JEI Report No. 22A, June 9, 1989.)

But as the NIEs approach industrialized-country status, their economic advantages have diminished. Most significantly, labor costs calculated in national currencies are rising rapidly. Exacerbating this trend is the strengthening of the Korean and Taiwanese currencies against the dollar. While the realignment has not been as substantial as the adjustment in the yen-dollar exchange rate, it has reduced the cost advantages of producing in these countries for shipment back to Japan or to the United States. In short, the NIEs are no longer low-cost hosts for the kinds of labor-intensive industries (for example, textiles) that Japanese firms traditionally have located there.

While political uncertainties probably have had less influence on Japanese investment decisions in the NIEs than elsewhere, neither Hong Kong nor South Korea is immune from consideration of this factor. As mentioned above, Hong Kong is concerned about changes Beijing may seek in its capitalist economic structure after 1997. And South Korea's political strife in the past few years has included labor unrest that has disquieted some Japanese investors. Nevertheless, the moves that Seoul has made toward democratization have been encouraging (see JEI Report No. 26A, July 7, 1989).

There is another, albeit still relatively minor, reason that Japanese investors may look outside the NIEs for offshore production opportunities. A significant proportion of Japanese products made in the NIEs traditionally has been shipped to third markets, especially the United States. But with the United States running trade deficits with all four of the NIEs ($9.9 billion with South Korea, $14.1 billion with Taiwan, $2.5 billion with Singapore and $5.1 billion with Hong Kong in 1988), additional restrictions on their U.S.-bound shipments are possible. That prospect gives Japanese investors an added incentive to use other countries as a base to supply the U.S. market.

Although production of labor-intensive goods may no longer be as profitable in the NIEs as it has been, other endeavors are becoming more cost-effective. For example, some Japanese firms now are considering the NIEs for higher-technology investments. Perhaps more important is a shift by Japanese investors to industries that tap into the spending power of the NIEs themselves. That is, rather than concentrating efforts on the manufacture or assembly of lower cost goods for export, Japanese firms now are branching into hotels, retail outlets and wholesale distribution, financial services and other industries that depend on the patronage of NIE nationals and tourists.

In the meantime, investors are turning toward some of the countries aligned in the Association of Southeast Asian Nations for supplies of labor-intensive products. Japanese investors are not choosing Asean countries simply for new investment activities; there have been some reports of Japanese firms pulling out of a NIE in order to increase their presence in Southeast Asia. Four of the six Asean members are drawing increased attention: Malaysia, Thailand, Indonesia and the Philippines. (Of the other two members, Singapore is considered a NIE, while Brunei has tied its economic success almost exclusively to its oil reserves.)

The Southeast Asian countries can offer significantly lower costs to Japanese investors, as well as very attractive exchange rates. For example, one Japanese corporate executive estimated that labor costs in Thailand are 50 percent lower than those in Taiwan, while materials costs are 30 percent less. The fact that these countries are anxious to earn foreign exchange, at least partly to repay their existing debts, increases their willingness to provide attractive incentives for foreign investors.

It is misleading, however, to speak of Malaysia, Thailand, Indonesia and the Philippines as a unit, or as interchangeable host countries, for Japanese investments. Each has its own benefits and disadvantages -- as well as its own structure of investment incentives and restrictions.

Malaysia - Called a "new NIE" more often than any other Asean country, Malaysia accrues both the prestige of being viewed as a developing country success story and the significant foreign investment associated with its fairly low labor costs. A Japanese businessman was quoted in 1988 as estimating that investors can employ 10 people in Malaysia for the same price as one worker in Japan. Low costs are enhanced by an attractive exchange rate, good infrastructure, relatively high levels of education, and an atmosphere of political stability -- although the marked cleavage between the Malay and Chinese ethnic groups raises questions about the country's future stability. Japanese businessmen also say that Malaysian workers have developed a reputation for consistently good work. As a consequence, Japanese investment has been growing steadily in the past few years, reaching $387 million in FY 1988. Malaysia is best known for hosting a large number of foreign-owned electronics facilities, especially plants doing assembly and testing of integrated circuits. This has made Malaysia the third-largest semiconductor producer in the world, according to the Malaysia-America Electronics Industry Association.

In fact, export-oriented foreign direct investment has been the driving force behind Malaysia's development thus far. Foreign investment made up some 75 percent of total investment in Malaysia in 1988 alone. Recognizing the importance of foreign involvement in the country's economy, Kuala Lumpur has eased its investment restrictions. For example, foreigners once were allowed to own no more than 30 percent of a given venture but now may wholly own a company as long as they meet one of two criteria: export at least 50 percent of the company's output or employ at least 350 Malaysian workers.

Not all Malaysians, however, are embracing what they see as an overreliance on foreign investment. These critics, often individual or corporate Malaysian investors, complain that the overly generous incentives given to foreign firms are squeezing out domestic investment activity. For the time being, however, these arguments are faint against the clout posed by prospective gains in employment, technology and foreign exchange from overseas manufacturing plants.

Some Malaysian officials also are worried about overconcentration in the electronics industry. The breadth of this concern remains unclear, but the automotive industry provides one example of how intent Kuala Lumpur is on expanding its export prowess into other areas. The Malaysian government is determined to make the Proton Saga -- in which the Mitsubishi Group owns a 30 percent stake -- an internationally distributed car. But because the financial incentives behind the drive do not appear great, many analysts have suggested that the Proton efforts are taking the form of a national symbol of Malaysia's determination to join the ranks of the industrialized world.

That such nationalism imposes costs on the foreign partner is clear. Another increasingly important consideration is that economic development is working to raise labor costs in the country. Each additional foreign venture experiences increasing difficulties in finding laborers, especially skilled workers. The Japan Economic Journal quoted one Japanese executive as saying that at the beginning of 1988 his firm received 800 applicants for 30 available positions; by the end of the year the response had dropped to 100 applicants, a trend that could portend problems for the future.

Thailand - The allure of Thailand lies in many of the same reasons that Malaysia provides an attractive investment environment. The government is politically stable (despite periodic shifts within the governing military elite), has a large and disciplined labor force and actively promotes foreign investment. Since Thailand's level of economic development lags slightly behind that of Malaysia, investors face more infrastructural problems. On the positive side, wages are lower in Thailand than Malaysia. Moreover, some analysts have suggested that because Thailand is overwhelmingly Buddhist, Japanese firms may feel more comfortable there than in other countries, such as predominantly Islamic Malaysia. The importance of cultural factors like religion in influencing investment decisions is impossible to measure, however, and therefore remains open to debate.

Thailand, like Malaysia, has gone out of its way to attract foreign investment by providing tax and other incentives. And, although the increasing Japanese presence does cause occasional resentful references to the World War II Greater East Asia Co-Prosperity Sphere, official attitudes toward Japanese investment are positive. One Thai politician summed up Bangkok's attitude toward Japanese investment activities: "It sure beats borrowing."

But Thailand is not without problems. The greatest obstacle to increased Japanese investment in the country is lack of physical space. Investment is centered overwhelmingly around Bangkok, which is fast becoming saturated. Factory and office space as well as residences are becoming more difficult, and more expensive, to obtain. As land prices rise around Bangkok so, too, does local resentment of Japanese activities.

Another hindrance is a shortage of skilled workers. The growing number of Japanese firms in the country has strained the supply of qualified engineers and managers. Companies have been known to lure skilled workers away from other plants with offers of huge salary increases. Domestic firms complain that they cannot match the larger salaries and can only watch the resulting internal "brain drain" as Thai engineers shift over to Japanese-affiliated companies. Nor are Japanese firms happy about the situation. The soaring pay scale for skilled employees is counteracting the benefits of low wages for factory workers and could negate such advantages altogether if the supply of Thai engineers does not expand. Another consequence of this shortage is that Japanese firms find it difficult to obtain high-quality parts from local producers; Thai suppliers respond that it is difficult to meet the standards imposed by Japanese firms when all their top employees are moving over to work in Japanese companies.

Indonesia - Although Jakarta's investment regulations have tended to be much more restrictive than those of Malaysia and Thailand, its political attitude more nationalistic and its overall post-Suharto stability more questionable, the cumulative dollar amount of Japanese investment in the country is

roughly five times that in Malaysia, Thailand and the Philippines and even higher than in any of the NIEs. The reason is simple: Indonesia has oil and other natural resources Japan needs. Japanese companies have been willing to accept greater risks to secure supplies of industrial raw materials than to produce manufactured goods. But Indonesia's traditional limitations on investments also have led Japanese firms to concentrate their efforts on extractive industries.

Still, Indonesia does have large numbers of available workers -- a plus that is becoming increasingly rare in Malaysia and (to a lesser extent) in Thailand. And, although its level of economic development is lower than either of those countries', the infrastructure on the main island, Java, is relatively good. Perhaps more important are the indications that the Suharto regime is willing to increase its incentives for foreign investors. As Indonesia's oil revenues decline because of the fall in prices, the country is looking to increase its manufacturing prowess; foreign firms can help build a manufacturing export base. Moreover, as Indonesia privatizes its government-owned industries, it will need companies willing and financially able to take them over. Foreigners meet the latter criterion but still need to be convinced for the former.

In fact, Jakarta has been easing its investment restrictions. For example, the minimum investment for foreign firms has been reduced from $1 million to $250,000 -- although additional conditions are imposed on smaller investors to ensure that the venture will create either exports or jobs. Similarly, whereas foreign investors formerly were limited to a 49 percent stake in any given venture, they now can hold 55 percent of a firm if at least 20 percent of the company's shares is listed on the Jakarta Stock Exchange. Also, in the past few years the government has shortened considerably its list of sectors in which foreign investment is forbidden.

Against the backdrop of official attempts to attract manufacturing investment, Japanese interest for the short term appears to continue to be based primarily on Indonesia's oil and natural gas reserves, since the country remains Japan's geographically closest energy supplier and its major source outside of the Middle East. But the longer run potential of Indonesia remains enormous and, as will be discussed in the next section, Japanese investors are exploring the possibility of setting up some manufacturing facilities in Indonesia as part of an integrated Asean production scheme.

Philippines - Attracting the least amount of investor confidence among the Asean countries is the Philippines, which pulled in only $134 million of Japanese investment in FY 1988. As the Japan Bond Research Institute ratings indicate, Japanese firms find the low level of economic development and the constant political tremors a strong disincentive to locating their ventures in the Philippines. Reports of labor unrest in the past several years as well as the constant threat of terrorist strikes by rebel forces have only added to investors' concerns.

On the plus side, wages in the Philippines are extremely low compared with other Asian countries. Manila also has offered foreign investors such attractive inducements as four- to six-year corporate tax holidays. Moreover, to stimulate the spread of foreign operations throughout the Philippines, Manila is planning to build industrial centers and special zones aimed at attracting investors. The goal is to build up physical infrastructure to the point that

foreign investors in various parts of the country will be able to operate as profitably as they now do in Manila.

Not all government policies aim at enticing investors, however. For example, a requirement that any venture have at least 60 percent local equity not only precludes a majority-owned Japanese facility but puts a heavy burden on Filipino investors to raise 60 percent of the funds needed to start up a venture. Nevertheless, one factor that is making the Philippines more attractive to Japanese investors involves the growing concerns regarding Hong Kong's political instability, Taiwan's (and, to a lesser extent, Malaysia's) increasing costs, and the physical "saturation" of Thailand. The Philippines is drawing manufacturers of labor-intensive products that otherwise might have gone elsewhere. As a result, increasing numbers of Japanese firms in the Philippines are manufacturing or assembling toys, textiles and apparel, and some consumer electronics items.

The Philippines also exemplifies an interesting development in the composition of foreign investment in Southeast Asia. No longer are Japan and the United States unquestionably the most important investors in the region. Firms from the newly industrialized economies are establishing greater numbers of overseas facilities in low-wage Southeast Asian countries, such as the Philippines and Indonesia. In fact, according to the Asian Wall Street Journal, Japan now ranks third among foreign investors in the Philippines -- after the United States and Taiwan.

Changing Composition of Investment in Asia

It is no surprise that Japanese firms tend to establish different types of manufacturing facilities in Southeast Asia today than they did 20 years ago. Indeed, Japanese investments have become more complex as companies have gained experience in operating offshore ventures. Initially Japanese firms located overseas to establish resource development centers and to take advantage of low labor costs to assemble products. Contemporary investors are more likely to manufacture products abroad as well as do assembly. Product lines, too, have changed. Although Japanese firms still find developing countries to be good places for traditional labor-intensive industries like textiles and apparel, they are seeing added benefits in establishing Asian subsidiaries that produce more sophisticated products -- such as consumer electronics and automotive components.

Asean-based facilities are winning more and more parts and materials work for a number of reasons. The ongoing strength of the yen makes procurement of large proportions of low-technology inputs from Japanese suppliers prohibitively expensive. Moreover, Asean countries have been able, for the most part, to improve the quality of the parts produced by local firms, whether these firms are locally owned or Japanese-affiliated. And, domestic content laws in many of the countries described above often make locally produced parts a requisite for foreign investors.

Consequently, corporate purchases of inputs made overseas have soared. Hitachi, Ltd., for example, estimated that its purchases of foreign-produced parts in FY 1988 would be 40 percent higher than the year before and that purchases of Asian-made foreign parts would increase by 50 percent. Even more pointedly, some Japanese firms have suggested to their domestic suppliers that

it would be beneficial to locate plants overseas. The Japan Economic Journal reported that Nissan Motor Co., Ltd. hopes that between 50 and 100 of its roughly 300 suppliers in Japan will open subsidiaries elsewhere in Asia.

Asean countries themselves have encouraged the move toward establishing what has been called a "global buying network." In fact, some governments have even given preferential treatment to investors that want to produce parts rather than finished products. In Thailand, for example, parts manufacturers receive an exemption from some of the export requirements imposed on foreign manufacturers of finished products.

The buildup of components facilities in Southeast Asia has led to another phenomenon: a marked increase in intra-Asean trade. The horizontal trade links among Southeast Asian countries have strengthened. In fact, in its 1987 White Paper on International Trade and Investment, MITI noted a "growing tendency for Japanese industry, especially the electrical machinery industry, to view the Pacific Region as a single market from which to pursue a global corporate strategy."

The increased regional links are illustrated by MITI's latest Survey of Business Activities Overseas. According to the study, 54.7 percent of the total sales of Japanese production subsidiaries in Asia went to the local market in FY 1986, down from 66.9 percent in FY 1983. Roughly 15.8 percent was shipped to Japan (as opposed to 10.8 percent in FY 1983) and 29.5 percent was exported to third countries (up from 22.3 percent). Even more significantly, 12.8 percent of the total sales of Japanese subsidiaries in Asia involved exports to other Asian countries, an increase from 8.2 percent in FY 1983.

One example of the horizontal integration of Japanese subsidiaries in Southeast Asia is in the automotive industry. Mitsubishi Motors Corp. has proposed producing a regional car. The idea is to make the parts in various Asean countries for final assembly somewhere in Southeast Asia. According to MMC, the plan makes eminent sense based on simple cost calculations: if each Asean country produces a car in its entirety, that car would cost an estimated two to three times the price of a jointly manufactured vehicle.

Indonesia reportedly has expressed some concern about the idea on the grounds that it would gain less from the venture than the Asean countries charged with producing the car's higher value-added components. Still, the appeal of achieving greater economies of scale and tapping into a larger combined market is hard to ignore. Nissan reportedly also has embraced the idea of a regional automotive production network.

India: A Move Even Further South?

In contrast to its interest in Southeast Asia, Japan's investment in South Asia is still very small. But the prospects for ventures in the region, especially in India, are promising. Obvious benefits include India's extremely low wage structure as well as a relatively large number of skilled workers, especially scientists and engineers. But there is another appeal. Not only is there a growing domestic market in India, but the country provides an optimal export base for new markets, such as the Middle East, the Soviet Union and even Eastern Europe.

Some ventures are located there for unique reasons. For example, in 1979 Nitto Gelatin Co., Ltd. set up a venture to produce (among other things) ossein, a substance made from cattle bone collagen. The firm has said that because the cow is sacred in India, it was relatively easy to find people who collect cattle bones. Although this reason would not hold much appeal for other Japanese investors, the success of Nitto Gelatin might. Members of the Mitsubishi Group reportedly are considering locating in Kerala State, where Nitto Gelatin is located, to process partially finished toiletry products.

A more typical investment in India is in consumer electronics, especially the production of cathode-ray tubes for televisions. Mitsubishi Electric Corp., Hitachi and Toshiba Corp. all have established ventures to produce CRTs in India, primarily to service the fast-growing domestic market but also to tap into sales in Eastern Bloc nations. India has welcomed the investment as a way to acquire valuable technology -- not only for consumer items but also, perhaps, for more sophisticated electronics items (for example, computers).

Nevertheless, the appeal of India as a host for labor-intensive manufacturing is likely to be weak as long as there are alternatives in Southeast Asia. But if political instability in the Philippines or Indonesia grows -- or if Japanese firms wish to expand significantly the geographic scope of their markets -- South Asia will appear more inviting. Certainly in a longer-term perspective, as economic development proceeds in East and Southeast Asia, South Asia may well be the next-generation host for foreign investment in labor-intensive industries. As such, it could attract investors from Japan, the United States, NIEs and possibly even Southeast Asia.

Capitalist Investors in Socialist Nations: China

Whatever their ideological line on capitalism, a growing number of socialist countries are busy promoting foreign economic activity within their borders. The most obvious example of this is the People's Republic of China. The prospect of their neighbor's low wages and enormous market potential cannot help but pique the interest of Japanese investors, but they have proceeded warily. Complicating the difficulties of producing in a radically different economic and political environment is an extremely unwieldy Chinese bureaucratic structure.

The June 4 slaughter of Chinese demonstrators and the ensuing global reaction illustrate only too well the risks of investing in China. Although Japan came under international criticism for the speed with which businessmen returned to their existing operations in China (see JEI Report No. 25B, June 30, 1989), the political incident only reinforced doubts regarding China's viability as a stable investment climate for Japanese enterprises.

The political uproar also exacerbated already-held reservations stemming from a number of longtime thorns in the side of investors. Foremost among these are investment restrictions imposed by Beijing. Although a major incentive for locating in China is the opportunity to tap into the enormous domestic market, other forces compel investors to produce for export. Specifically, a firm that produces solely for local consumption will earn only local currency. Although it is possible to exchange renminbi at official exchange centers, those who do must pay huge premiums. Beijing has made some changes to mitigate the problem; for example, it allows investors to sell some goods in China for foreign

currency. Still, investors must export a certain percentage of their output in order to obtain enough foreign exchange to continue to supply their plants with the parts and other supplies that they must obtain from abroad.

Another irritant is Beijing's retention of the right to examine foreign investment plans on a case-by-case basis. In doing so, the government often weighs the export potential of the venture. Based on past results, those investors aiming primarily at the domestic market expect to encounter more difficulties than those who wish to export.

Official incentives for investors have offset these obstacles somewhat. Foreign investors enjoy a two-year tax holiday, followed by a three- to six-year period of paying only 50 percent of their tax assessments. Beijing also has set up special zones in coastal areas, in which foreign investors enjoy favorable tax treatment. (Investors tend to be treated more favorably in the southern part of China, such as Guangdong Province; restrictions on foreign firms become tighter as they get closer to Beijing.) Japanese investors recently received even more favorable treatment in the form of an investment protection pact, which provides Japanese firms with the same status as Chinese firms. The effectiveness of this pact, which was signed in April by the two governments, remains open to question in the wake of the student massacre.

The current composition of Japanese activities in China reveals few surprises. The bulk of Japanese investment there consists of labor-intensive manufacturing or assembly and natural resource industries. One example is the Beijing-Matsushita Color CRT Co., a joint venture in which Matsushita Electric Industrial Co., Ltd. and Matsushita Electronics Corp. are equal partners with a group of Chinese corporations. The firm has been producing cathode-ray tubes for export to other Asian countries. Beijing stresses the venture's potential to develop China's ability to produce televisions and other consumer electronics items. The Matsushita Group liked the idea of having a low-cost overseas parts supplier. Again, however, the effect of the current political situation is bound to increase the costs -- at least in terms of uncertainty -- of relying on a China-based parts supplier.

It seems unlikely that Japanese businessmen would abandon China completely, despite the turmoil. The draw of the domestic market and of cheap labor remains great. However, the ultimate outcome will depend almost exclusively on Chinese policies. If political hard-liners gain the upper hand in Beijing, the result could be an isolationist or tight, centrally controlled policy that alienates foreign investors of all nationalities. But if economic reformers gain greater influence, they could well implement even more investment incentives in an attempt to persuade foreign firms to overlook the Tiananmen Square incident. These are longer-term considerations, however. For the time being, it seems reasonable to assume that Japanese and other foreign investment in China will be stagnant and that it will take some convincing on Beijing's part to persuade foreigners to commit significant additional resources to the country.

The Untapped Socialist Countries

Japanese firms have shown far greater reluctance to establish a presence in the other Asian socialist countries. The domestic obstacles regarding Vietnam -- serious political risks, inadequate infrastructure and poverty -- are not nearly as daunting as an international factor: the possibility of incurring

U.S. (or, to a lesser extent, Asean) wrath by establishing close ties with Vietnam. Indeed, Hanoi is doing everything possible to attract foreign capital, including allowing foreign investors 99 percent ownership in joint ventures (and full ownership in specific cases). Moreover, firms that establish ventures in areas that the government would like to promote are granted tax incentives. Among the favored candidates are export-oriented firms, ventures that employ a large number of Vietnamese workers and those that earn foreign exchange.

The incentives have attracted the interest of a number of foreign firms. The Wall Street Journal reports that Vietnam is now host to investment from Australia, Canada, India, Indonesia, South Korea, Thailand, Hong Kong and Singapore. Conspicuously absent from this list are the United States and Japan. America thus far has refused to consider normalizing relations with Vietnam, primarily because of its occupation of Cambodia and unresolved questions regarding Hanoi's knowledge of the whereabouts of American soldiers classified as missing in action from the Vietnam conflict. Although Japanese firms trade with Vietnam, none has moved to set up production facilities there. Until Japanese firms receive an indication that investing in Vietnam is unlikely to provoke American anger, they probably will continue to forgo the still-limited benefits of investing there in favor of preserving sound relations with Japan's major trading partner, the United States.

The case of Myanmar (formerly Burma) is slightly different. Japanese firms have not flocked to invest there, but neither have other foreign firms expressed great interest. Although the government has approved liberal foreign investment regulations, it did so only last December. Despite the less restrictive investment environment, some of the new regulations are vague -- an unsettling circumstance for prospective investors. So far Yangon's new regulations reportedly have attracted only one U.S. investor, which plans to process hardwood. There have been no indications of Japanese takers, but reports that Myanmar has substantial onshore oil deposits will ensure that Japanese firms continue to follow the situation closely.

The newness of the regulations might explain the lack of movement by Japanese companies, but continued political uncertainties about the country probably are a bigger factor. The government has attempted to ease foreign worries about the country's stability by promising to have open elections later this year and by reopening Myanmar universities. But observers have expressed doubts about the military government's stability and the likelihood that elections will indeed be held. An opposition party leader told the Asian Wall Street Journal that new investments could actually harm the prospects for elections since the increased economic activity could persuade the government that it can maintain the status quo indefinitely. Whether or not this scenario is accurate, it probably will not be put to the test. Prospective investors are more likely to wait for the promised elections before making any final decisions to increase their activities in the country. Political stability is simply too tenuous to do otherwise.

On a similar note, North Korea has attracted little in the way of Japanese investment, although bilateral trade has expanded slowly since the 1970s. Pyongyang has targeted Japan especially in its attempts to attract foreign investment -- for example, by specifically naming Japan in its 1984 joint venture law (see JEI Report No. 26A, July 7, 1989). But from the perspective of Japanese firms, there is little to gain in North Korea, except the opportunity for

access to raw materials, and much to lose. Not only are the political risks and structural problems severe in North Korea, but establishing closer economic ties could jeopardize Japanese links with a much more important economic and political ally, South Korea.

In The United States' Back Yard . . .

In terms of total Japanese foreign direct investment, Latin America is the only developing region that rivals Asia. As mentioned above, however, the statistics are misleading: they incorporate a significant amount of nonmanufacturing "paper investment." A closer look reveals only two countries that have enjoyed an increase in Japanese manufacturing investment in recent years: Brazil and Mexico.

The dynamics of investing in Brazil tend to be quite different from those in Asian countries. For one, the country has embraced a development policy that relies heavily (although not exclusively) on import substitution. Partly as a result of this, Brazilian policymakers are quite ambivalent about foreign investment. Rather than embracing it as a way to acquire valuable technologies, they believe that foreign investors may dominate the domestic market in strategic industries and squeeze domestic firms out. Consequently, Brazil has placed significant restrictions on foreign investment in the "informatics" industry -- a vague term that can cover virtually any electronics-related product.

Moreover, restrictions on foreign investment are tight. Brasilia has enacted strict local content and local employee laws. The pressure on foreign firms to export is intense. Perhaps even more worrisome to prospective investors is the attitude of government officials, who sometimes do not hesitate to criticize the activities of multinational corporations. One Brazilian senator was quoted as saying that U.S. automotive companies should not insist on 100 percent U.S. ownership since, "in the future, they might be nationalized." Remarks such as this do not inspire confidence in the investment environment.

According to Leon Hollerman in his 1988 book, Japan's Economic Strategy in Brazil, 15 of Brazil's leading export firms are either wholly or largely Japanese-owned. They consist of four mining companies, two trading companies, two textile companies, and one each in iron ore pellets, aluminum, wood pulp, forestry, frozen products, pharmaceuticals and steel.

Japanese corporate interest in Mexico these days is directed overwhelmingly toward its proximity to the United States. In geographic terms the country is an ideal base from which to supply the United States. Also appealing are the low labor costs and Mexico's eligibility for the U.S. generalized system of preference eligibility (a benefit the NIEs lost at the end of 1988).

But Mexico has stiff laws governing local content, local employment and export requirements. These would be a significant deterrent were it not for the exceptions granted to "maquiladoras" -- assembly plants located just across the border from the United States. The maquiladora program is based on an agreement between the United States and Mexico; firms that assemble products in the region are exempt from Mexican investment restrictions and must pay U.S. duties only on the value added when the finished product is reexported to the United States. The agreement has benefited both sides. U.S. firms enjoy the extremely

low labor costs associated with assembly work in a developing country while gaining the benefits of easy access to this country for inputs, maintenance, customer feedback and so forth. U.S. maquiladora employees also are able to conveniently live in the United States while working in Mexico. For its part, Mexico has seen its employment rate rise significantly. The northern border region now generates a disproportionate amount of Mexico's gross national product.

Although more than 90 percent of the maquiladoras are American-owned, the program has caught the attention of other countries. Japanese firms in particular see the opportunity of using the maquiladora program to remain cost-competitive in the U.S. market. These firms have all the same reasons as U.S. firms to locate in Mexico -- plus one other. The current uncertainties over the future regulation of foreign investment in the United States make the maquiladora program an even more attractive option.

Several Japanese firms already have located plants in the maquiladora region, including Matsushita Electric Industrial, Sanyo Electric Co., Ltd., Sony Corp. and TDK Corp. All these firms had production facilities in the United States before setting up their maquiladora plants; consequently, it is easy for them to access parts and other inputs from their U.S. subsidiaries. Although the number of Japanese firms in Mexico is not huge, there is every indication that it will continue to grow. A 1988 study by the U.S. International Trade Commission, for example, predicted that Japanese firms will invest up to $3 billion in Mexico between 1987 and 1990; much of this will be in the maquiladora region.

Despite the attractiveness of the program, the maquiladoras are not without problems. High employee turnover frustrates Japanese companies accustomed to operating under a lifetime (or at least long-term) employment system. A high absentee rate also poses problems; plant managers are reportedly happy when employee absences fall below 10 percent. Moreover, Japanese managers must deal with language barriers and cultural clashes. Techniques that work well in Southeast Asia -- such as quality control circles or company calisthenics -- may fail miserably in Mexico.

Another major worry is the as-yet muted reaction of the United States to a significant increase in the number of Japanese facilities operating near the U.S.-Mexican border. U.S. critics of the maquiladora program claim the Mexican plants create jobs for Mexicans that otherwise would go to U.S. workers. If the program also becomes viewed as a mechanism for Japanese products to slip into the United States, opposition is likely to grow. Similarly, if Mexican policymakers conclude that Japanese activities are jeopardizing the program, they could decide to impose restrictions on non-U.S. investors. Japanese investors are not likely to bypass the benefits of the maquiladora program, but they most certainly will proceed with one eye firmly fixed on Washington.

Conclusion

Japanese investors do not appear overly anxious to diversify their manufacturing investments in developing countries beyond Asia, except insofar as ventures in Latin America can tap into the U.S. market and investments in the Middle East can secure valuable oil supplies. Even a cursory look at investment figures shows that, despite the popular perception of Japanese businesses

"buying up" the world, firms actually are proceeding cautiously in areas that are politically unstable or culturally different.

But Japanese investors are significantly expanding their activities in Southeast Asia -- looking for new locations as well as broadening the types of ventures. Perhaps more important in the longer run, investors are toying with the option of setting up regional production networks. Just how far such a policy will go toward promoting regional integration is still uncertain. Nonetheless, Asean countries are counting on foreign investment to lead to the same kind of economic development that moved Singapore, Taiwan, South Korea and Hong Kong into the ranks of newly industrialized economies.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.